

HMN FINANCIAL INC  
Form 10-Q  
May 07, 2015  
**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2015

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-24100

**HMN FINANCIAL, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

41-1777397  
(I.R.S. Employer Identification No.)

1016 Civic Center Drive N.W., Rochester, MN  
(Address of principal executive offices)

55901  
(ZIP Code)

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Registrant's telephone number, including area code: (507) 535-1200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes      No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes      No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer   Accelerated filer   Non-accelerated filer   Smaller reporting company  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes      No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

| Class                          | Outstanding at April 21, 2015 |
|--------------------------------|-------------------------------|
| Common stock, \$0.01 par value | 4,480,258                     |

**HMN FINANCIAL, INC.**

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**PART I – FINANCIAL INFORMATION****Item 1 : Financial Statements****HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Balance Sheets**

| <i>(Dollars in thousands)</i>   | March 31,<br>2015<br>(unaudited) | December<br>31,<br>2014 |
|---|----------------------------------|-------------------------|
| <b>Assets</b>   |                                  |                         |
| Cash and cash equivalents   | \$ 22,936                        | 46,634                  |
| Securities available for sale:  |                                  |                         |
| Mortgage-backed and related securities (amortized cost \$2,348 and \$2,755) | 2,471                            | 2,909                   |
| Other marketable securities (amortized cost \$151,835 and \$135,772)        | 151,674                          | 134,925                 |
|   | 154,145                          | 137,834                 |
| Loans held for sale   | 2,663                            | 2,076                   |
| Loans receivable, net   | 360,370                          | 365,113                 |
| Accrued interest receivable   | 1,941                            | 1,713                   |
| Real estate, net  | 2,966                            | 3,103                   |
| Federal Home Loan Bank stock, at cost                                       | 691                              | 777                     |
| Mortgage servicing rights, net  | 1,448                            | 1,507                   |
| Premises and equipment, net   | 6,919                            | 6,982                   |
| Prepaid expenses and other assets   | 1,139                            | 1,157                   |
| Deferred tax asset, net   | 10,269                           | 10,530                  |
| Total assets  | \$ 565,487                       | 577,426                 |
| <b>Liabilities and Stockholders' Equity</b>                                 |                                  |                         |
| Deposits  | \$ 483,323                       | 496,750                 |
| Other borrowings  | 10,000                           | 0                       |
| Accrued interest payable  | 166                              | 93                      |
| Customer escrows  | 1,228                            | 788                     |
| Accrued expenses and other liabilities                                      | 3,995                            | 3,782                   |
| Total liabilities   | 498,712                          | 501,413                 |
| Commitments and contingencies   |                                  |                         |
| Stockholders' equity:   |                                  |                         |
| Serial preferred stock (\$.01 par value):                                   |                                  |                         |
| Authorized 500,000 shares; issued shares 0 and 10,000                       | 0                                | 10,000                  |
| Common stock (\$.01 par value):   |                                  |                         |
| Authorized 16,000,000; issued shares 9,128,662                              | 91                               | 91                      |

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|  |            |           |
|--|------------|-----------|
| Additional paid-in capital                             | 50,035     | 50,207    |
| Retained earnings, subject to certain restrictions     | 78,041     | 77,805    |
| Accumulated other comprehensive loss                   | (23 )      | (418 )    |
| Unearned employee stock ownership plan shares          | (2,562 )   | (2,610 )  |
| Treasury stock, at cost 4,648,404 and 4,658,323 shares | (58,807 )  | (59,062 ) |
| Total stockholders' equity                             | 66,775     | 76,013    |
| Total liabilities and stockholders' equity             | \$ 565,487 | 577,426   |

See accompanying notes to consolidated financial statements.

**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income**

(unaudited)

|  | Three Months<br>Ended |         |
|--|-----------------------|---------|
|  | March 31,             |         |
|  | 2015                  | 2014    |
| <i>(Dollars in thousands, except per share data)</i> |                       |         |
| Interest income:                                     |                       |         |
| Loans receivable                                     | \$4,354               | 5,070   |
| Securities available for sale:                       |                       |         |
| Mortgage-backed and related                          | 28                    | 50      |
| Other marketable                                     | 486                   | 254     |
| Cash equivalents                                     | 15                    | 52      |
| Other  | 1                     | 1       |
| Total interest income                                | 4,884                 | 5,427   |
| Interest expense:                                    |                       |         |
| Deposits   | 248                   | 334     |
| Other borrowings                                     | 78                    | 0       |
| Total interest expense                               | 326                   | 334     |
| Net interest income                                  | 4,558                 | 5,093   |
| Provision for loan losses                            | 0                     | (1,610) |
| Net interest income after provision for loan losses  | 4,558                 | 6,703   |
| Non-interest income:                                 |                       |         |
| Fees and service charges                             | 782                   | 823     |
| Loan servicing fees                                  | 261                   | 261     |
| Gain on sales of loans                               | 285                   | 346     |
| Other  | 268                   | 258     |
| Total non-interest income                            | 1,596                 | 1,688   |
| Non-interest expense:                                |                       |         |
| Compensation and benefits                            | 3,448                 | 3,478   |
| (Gain) loss on real estate owned                     | (112 )                | 68      |
| Occupancy  | 879                   | 882     |
| Deposit insurance                                    | 70                    | 157     |
| Data processing                                      | 231                   | 246     |
| Other  | 917                   | 866     |
| Total non-interest expense                           | 5,433                 | 5,697   |
| Income before income tax expense                     | 721                   | 2,694   |
| Income tax expense                                   | 260                   | 1,062   |
| Net income   | 461                   | 1,632   |

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|  |        |        |
|--|--------|--------|
| Preferred stock dividends                                | (108 ) | (532 ) |
| Net income available to common shareholders              | \$353  | 1,100  |
| Other comprehensive income, net of tax                   | \$395  | 181    |
| Comprehensive income attributable to common shareholders | \$748  | 1,281  |
| Basic earnings per common share                          | \$0.09 | 0.27   |
| Diluted earnings per common share                        | \$0.08 | 0.24   |

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See accompanying notes to consolidated financial statements.



**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statement of Stockholders' Equity****For the Three Month Period Ended March 31, 2015**

(unaudited)

| <i>(Dollars in thousands)</i>                  | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss) | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Total<br>Stock-<br>Holders'<br>Equity |
|--|--------------------|-----------------|----------------------------------|----------------------|--|--|-------------------|---------------------------------------|
| Balance, December 31, 2014                     | \$ 10,000          | 91              | 50,207                           | 77,805               | (418 )   | (2,610 )   | (59,062)          | 76,013                                |
| Net income                                     |                    |                 |                                  | 461                  |  |  |                   | 461                                   |
| Other comprehensive income                     |                    |                 |                                  |                      | 395  |  |                   | 395                                   |
| Redemption of preferred stock                  | (10,000)           |                 |                                  |                      |  |  |                   | (10,000)                              |
| Restricted stock awards                        |                    |                 | (255 )                           |                      |  |  | 255               | 0                                     |
| Amortization of restricted<br>stock awards     |                    |                 | 67                               |                      |  |  |                   | 67                                    |
| Preferred stock dividends                      |                    |                 |                                  | (225 )               |  |  |                   | (225 )                                |
| Earned employee stock<br>ownership plan shares |                    |                 | 16                               |                      |  | 48   |                   | 64                                    |
| Balance, March 31, 2015                        | \$ 0               | 91              | 50,035                           | 78,041               | (23 )  | (2,562 )   | (58,807)          | 66,775                                |

See accompanying notes to consolidated financial statements.

**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

(unaudited)

|   | Three Months<br>Ended |           |
|---|-----------------------|-----------|
|   | March 31,             |           |
|   | 2015                  | 2014      |
| <i>(Dollars in thousands)</i>   |                       |           |
| Cash flows from operating activities:   |                       |           |
| Net income  | \$461                 | 1,632     |
| Adjustments to reconcile net income to cash provided by operating activities: |                       |           |
| Provision for loan losses   | 0                     | (1,610 )  |
| Depreciation  | 161                   | 131       |
| Amortization of premiums, net   | 6                     | 7         |
| Amortization of deferred loan (fees) costs                                    | (31 )                 | 5         |
| Amortization of mortgage servicing rights                                     | 143                   | 116       |
| Capitalized mortgage servicing rights   | (84 )                 | (38 )     |
| (Gain) loss on sales of real estate and premises                              | (112 )                | 68        |
| Gain on sales of loans  | (285 )                | (346 )    |
| Proceeds from sale of loans held for sale                                     | 12,061                | 9,053     |
| Disbursements on loans held for sale  | (12,027)              | (4,890 )  |
| Amortization of restricted stock awards                                       | 67                    | 56        |
| Amortization of unearned ESOP shares  | 48                    | 49        |
| Earned employee stock ownership shares priced above original cost             | 16                    | 11        |
| (Increase) decrease in accrued interest receivable                            | (228 )                | 61        |
| Increase (decrease) in accrued interest payable                               | 72                    | (39 )     |
| Decrease (increase) in other assets   | 50                    | (575 )    |
| Increase in other liabilities   | 209                   | 1,299     |
| Other, net  | 9                     | 293       |
|   | 536                   | 5,283     |
| Net cash provided by operating activities                                     |                       |           |
| Cash flows from investing activities:   |                       |           |
| Principal collected on securities available for sale                          | 409                   | 699       |
| Proceeds collected on maturities of securities available for sale             | 18,000                | 10,000    |
| Purchases of securities available for sale                                    | (34,070)              | (5,003 )  |
| Redemption of Federal Home Loan Bank stock                                    | 86                    | 7         |
| Proceeds from sales of real estate and premises                               | 221                   | 136       |
| Net decrease (increase) in loans receivable                                   | 4,431                 | (542 )    |
| Purchases of premises and equipment   | (99 )                 | (205 )    |
|   | (11,022)              | 5,092     |
| Net cash (used) provided by investing activities                              |                       |           |
| Cash flows from financing activities:   |                       |           |
| Decrease in deposits  | (13,428)              | (31,550 ) |

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|  |          |           |
|--|----------|-----------|
| Redemption of preferred stock                  | (10,000) | 0         |
| Dividends to preferred stockholders            | (225 )   | 0         |
| Proceeds from borrowings                       | 13,000   | 0         |
| Repayment of borrowings                        | (3,000 ) | 0         |
| Increase in customer escrows                   | 441      | 505       |
| Net cash used by financing activities          | (13,212) | (31,045 ) |
| Decrease in cash and cash equivalents          | (23,698) | (20,670 ) |
| Cash and cash equivalents, beginning of period | 46,634   | 120,686   |
| Cash and cash equivalents, end of period       | \$22,936 | 100,016   |
| Supplemental cash flow disclosures:            |          |           |
| Cash paid for interest                         | \$254    | 373       |
| Cash paid for income taxes                     | 135      | 0         |
| Supplemental noncash flow disclosures:         |          |           |
| Loans transferred to loans held for sale       | 342      | 3,742     |

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See accompanying notes to consolidated financial statements

## HMN FINANCIAL, INC. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

(unaudited)

#### **(1) *HMN Financial, Inc.***

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production facilities in Minnesota, Iowa, and Wisconsin. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which acts as an intermediary for the Bank in holding and operating certain foreclosed properties.

The consolidated financial statements included herein are for HMN, the Bank, OIA and HPH. All significant intercompany accounts and transactions have been eliminated in consolidation.

#### **(2) *Basis of Preparation***

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the three-month period ended March 31, 2015 are not necessarily indicative of the results which may be expected for the entire year.

#### **(3) *Derivative Instruments and Hedging Activities***

The Company had commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate or sell loans on a firm commitment basis are derivatives and are recorded at market value. As a result of marking these derivatives to market for the period ended March 31, 2015, the Company recorded an increase in other assets of \$32,000, an increase in other liabilities of \$25,000 and a gain included in the gain on sales of loans of \$7,000. As a result of marking these derivatives to market for the period ended March 31, 2014, the Company recorded an increase in other assets of \$9,000, an increase in other liabilities of \$5,000 and a gain included in the gain on sales of loans of \$4,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower-of-cost-or-market. The Company recorded an increase in other liabilities of \$3,000 and a loss included in the gain on sales of loans of \$3,000 for both the periods ended March 31, 2015 and March 31, 2014.

**(4) Fair Value Measurements**

ASC 820, *Fair Value Measurements*, establishes a framework for measuring the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets that the Company has the ability to access.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use significant assumptions not observable in the market and are used only to the extent that observable inputs are not available. These unobservable assumptions reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following table summarizes the assets of the Company for which fair values are determined on a recurring basis as of March 31, 2015 and December 31, 2014.

Carrying value at March 31, 2015

| <i>(Dollars in thousands)</i> | Total      | Level<br>1 | Level 2 | Level<br>3 |
|-------------------------------|------------|------------|---------|------------|
| Securities available for sale | \$ 154,145 | 0          | 154,145 | 0          |
| Mortgage loan commitments     | 48         | 0          | 48      | 0          |
| Total                         | \$ 154,193 | 0          | 154,193 | 0          |

Carrying value at December 31,  
2014

| <i>(Dollars in thousands)</i> | Total      | Level<br>1 | Level 2 | Level<br>3 |
|-------------------------------|------------|------------|---------|------------|
| Securities available for sale | \$ 137,834 | 0          | 137,834 | 0          |
| Mortgage loan commitments     | 16         | 0          | 16      | 0          |
| Total                         | \$ 137,850 | 0          | 137,850 | 0          |

There were no transfers between Levels 1, 2, or 3 during the three months ended March 31, 2015.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis that were still held at March 31, 2015 and December 31, 2014, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at March 31, 2015 and December 31, 2014.

Carrying value at March 31,  
2015

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| <i>(Dollars in thousands)</i>   | Total    | Level<br>1 | Level 2 | Level<br>3 | Three<br>months<br>ended   |
|---------------------------------|----------|------------|---------|------------|----------------------------|
|                                 |          |            |         |            | March<br>31,<br>2015       |
|                                 |          |            |         |            | total<br>gains<br>(losses) |
| Loans held for sale             | \$2,663  | 0          | 2,663   | 0          | 25                         |
| Mortgage servicing rights, net  | 1,448    | 0          | 1,448   | 0          | 0                          |
| Loans <sup>(1)</sup>            | 10,812   | 0          | 10,812  | 0          | (43 )                      |
| Real estate, net <sup>(2)</sup> | 2,966    | 0          | 2,966   | 0          | 0                          |
| Total                           | \$17,889 | 0          | 17,889  | 0          | (18 )                      |

Carrying value at December 31,  
2014

| <i>(Dollars in thousands)</i>   | Total    | Level<br>1 | Level 2 | Level<br>3 | Year<br>ended              |
|---------------------------------|----------|------------|---------|------------|----------------------------|
|                                 |          |            |         |            | December<br>31, 2014       |
|                                 |          |            |         |            | total<br>gains<br>(losses) |
| Loans held for sale             | \$2,076  | 0          | 2,076   | 0          | (1 )                       |
| Mortgage servicing rights, net  | 1,507    | 0          | 1,507   | 0          | 0                          |
| Loans <sup>(1)</sup>            | 11,882   | 0          | 11,882  | 0          | 532                        |
| Real estate, net <sup>(2)</sup> | 3,103    | 0          | 3,103   | 0          | (134 )                     |
| Total                           | \$18,568 | 0          | 18,568  | 0          | 397                        |

(1) Represents carrying value and related write-downs of loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.

(2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

**(5) Fair Value of Financial Instruments**

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 4, have been included in the following table for March 31, 2015 and December 31, 2014. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of March 31, 2015 and December 31, 2014 are shown below.

| <i>(Dollars in thousands)</i> | March 31, 2015  |                      |                      | December 31, 2014 |                      |                      |         |         |         |                 |
|-------------------------------|-----------------|----------------------|----------------------|-------------------|----------------------|----------------------|---------|---------|---------|-----------------|
|                               | Carrying amount | Estimated fair value | Fair value hierarchy | Carrying amount   | Estimated fair value | Fair value hierarchy |         |         |         |                 |
|                               |                 |                      | Level 1              | Level 2           | Level 3              | Contract amount      | Level 1 | Level 2 | Level 3 | Contract amount |
| Financial assets:             |                 |                      |                      |                   |                      |                      |         |         |         |                 |
| Cash and cash equivalents     | \$22,936        | 22,936               | 22,936               |                   |                      |                      | 46,634  | 46,634  | 46,634  |                 |
| Securities available for sale | 154,145         | 154,145              |                      | 154,145           |                      |                      | 137,834 | 137,834 |         | 137,834         |
| Loans held for sale           | 2,663           | 2,663                |                      | 2,663             |                      |                      | 2,076   | 2,076   |         | 2,076           |
| Loans receivable, net         | 360,370         | 360,346              |                      | 360,346           |                      |                      | 365,113 | 364,509 |         | 364,509         |
| Federal Home Loan Bank stock  | 691             | 691                  |                      | 691               |                      |                      | 777     | 777     |         | 777             |
| Accrued interest receivable   | 1,941           | 1,941                |                      | 1,941             |                      |                      | 1,713   | 1,713   |         | 1,713           |
| Financial liabilities:        |                 |                      |                      |                   |                      |                      |         |         |         |                 |
| Deposits                      | 483,323         | 483,152              |                      | 483,152           |                      |                      | 496,750 | 496,494 |         | 496,494         |
| Other borrowings              | 10,000          | 10,025               |                      | 10,025            |                      |                      | 0       | 0       |         | 0               |
| Accrued interest payable      | 166             | 166                  |                      | 166               |                      |                      | 93      | 93      |         | 93              |



|   |     |       |         |       |     |       |         |       |
|---|-----|-------|---------|-------|-----|-------|---------|-------|
| Off-balance<br>sheet<br>financial<br>instruments: |     |       |         |       |     |       |         |       |
| Commitments<br>to extend<br>credit                | 48  | 48    | 205,050 | 16    | 16  |       | 141,574 |       |
| Commitments<br>to sell loans                      | (58 | ) (58 | )       | 6,673 | (30 | ) (30 | )       | 3,279 |

*Cash and Cash Equivalents*

The carrying amount of cash and cash equivalents approximates their fair value.

*Securities Available for Sale*

The fair values of securities were based upon quoted market prices for identical or similar instruments in active markets.

*Loans Held for Sale*

The fair values of loans held for sale were based upon quoted market prices for loans with similar interest rates and terms to maturity.

*Loans Receivable, net*

The fair value of the loan portfolio, with the exception of the adjustable rate portfolio, was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio. The fair value of the adjustable loan portfolio was estimated by grouping the loans with similar characteristics and comparing the characteristics of each group to the prices quoted for similar types of loans in the secondary market.

*Accrued Interest Receivable*

The carrying amount of accrued interest receivable approximates its fair value since it is short-term in nature and does not present unanticipated credit concerns.

*Deposits*

The fair value of demand deposits, savings accounts and certain money market account deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

The fair value estimate for deposits does not include the benefit that results from the low cost funding provided by the Company's existing deposits and long-term customer relationships compared to the cost of obtaining different sources of funding. This benefit is commonly referred to as the core deposit intangible.

*Other Borrowings*

The fair values of other borrowings with fixed maturities are estimated based on discounted cash flow analysis using as discount rates the interest rates charged by the FHLB for borrowings of similar remaining maturities.

*Accrued Interest Payable*

The carrying amount of accrued interest payable approximates its fair value since it is short-term in nature.

*Commitments to Extend Credit*

The fair values of commitments to extend credit are estimated using the fees normally charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counter parties.

*Commitments to Sell Loans*

The fair values of commitments to sell loans are estimated using the quoted market prices for loans with similar interest rates and terms to maturity.

**(6) Other Comprehensive Income**

Other comprehensive income is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income is the total of net income and other comprehensive income, which for the Company is comprised of unrealized gains and losses on securities available for sale. The components of other comprehensive income and the related tax effects were as follows:

| <i>(Dollars in thousands)</i>  | For the period ended March 31, |     |            |     |
|--------------------------------|--------------------------------|-----|------------|-----|
|                                | 2015                           |     | 2014       |     |
|                                | Before Tax                     | Net | Before Tax | Net |
|                                | tax                            | of  | tax        | of  |
|                                | effect                         | tax | effect     | tax |
| Securities available for sale: |                                |     |            |     |

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|  |       |     |     |     |    |     |
|--|-------|-----|-----|-----|----|-----|
| Net unrealized gains arising during the period | \$655 | 260 | 395 | 239 | 58 | 181 |
| Other comprehensive income                     | \$655 | 260 | 395 | 239 | 58 | 181 |

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**(7) Securities Available For Sale**

The following table shows the gross unrealized losses and fair values for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2015 and December 31, 2014.

| <i>(Dollars in thousands)</i>         | March 31, 2015          |            |                   |                       |            |                   |                  |                   |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------------|-------------------|
|                                       | Less than twelve months |            |                   | Twelve months or more |            |                   | Total Fair Value | Unrealized Losses |
|                                       | # of Investments        | Fair Value | Unrealized Losses | # of Investments      | Fair Value | Unrealized Losses |                  |                   |
| Other marketable securities:          |                         |            |                   |                       |            |                   |                  |                   |
| U.S. Government agency Obligations    | 5                       | \$ 23,915  | (85 )             | 1                     | \$ 5,011   | (8 )              | \$ 28,926        | (93 )             |
| Corporate preferred stock             | 0                       | 0          | 0                 | 1                     | 350        | (350 )            | 350              | (350 )            |
| Corporate equity                      | 1                       | 57         | (1 )              | 0                     | 0          | 0                 | 57               | (1 )              |
| Total temporarily impaired securities | 6                       | \$ 23,972  | (86 )             | 2                     | \$ 5,361   | (358 )            | \$ 29,333        | (444 )            |
|                                       | December 31, 2014       |            |                   |                       |            |                   |                  |                   |
|                                       | Less than twelve months |            |                   | Twelve months or more |            |                   | Total Fair Value | Unrealized Losses |
| <i>(Dollars in thousands)</i>         | # of Investments        | Fair Value | Unrealized Losses | # of Investments      | Fair Value | Unrealized Losses |                  |                   |
| Other marketable securities:          |                         |            |                   |                       |            |                   |                  |                   |
| U.S. Government agency obligations    | 22                      | \$ 104,453 | (551 )            | 1                     | \$ 4,970   | (50 )             | \$ 109,423       | (601 )            |
| Corporate preferred stock             | 0                       | 0          | 0                 | 1                     | 420        | (280 )            | 420              | (280 )            |
| Total temporarily impaired securities | 22                      | \$ 104,453 | (551 )            | 2                     | \$ 5,390   | (330 )            | \$ 109,843       | (881 )            |

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the market liquidity for the investment, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and our intent and ability to hold the investment for a period of time sufficient to recover the temporary loss.

The unrealized losses reported for corporate preferred stock over twelve months at March 31, 2015 relates to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In September 2014, the issuer paid all previously deferred interest that was due and all payments were current as of September 30, 2014. In January 2015, the issuer deferred its scheduled interest payment as allowed by the terms of the security agreement. The issuer's subsidiary bank has incurred operating losses due to increased provisions for loan losses but still met the regulatory requirements to be considered "well capitalized" based on its most recent regulatory filing. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at March 31, 2015. The Company does not intend to sell the trust preferred security and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred security and the deferral of interest by the issuer. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

A summary of securities available for sale at March 31, 2015 and December 31, 2014 is as follows:

| <i>(Dollars in thousands)</i>                  | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| <u>March 31, 2015:</u>                         |                   |                              |                               |               |
| Mortgage-backed securities:                    |                   |                              |                               |               |
| Federal Home Loan Mortgage Corporation (FHLMC) | \$ 1,186          | 70                           | 0                             | 1,256         |
| Federal National Mortgage Association (FNMA)   | 1,162             | 53                           | 0                             | 1,215         |
|  | 2,348             | 123                          | 0                             | 2,471         |
| Other marketable securities:                   |                   |                              |                               |               |
| U.S. Government agency obligations             | 151,077           | 283                          | (93 )                         | 151,267       |
| Corporate preferred stock                      | 700               | 0                            | (350 )                        | 350           |
| Corporate equity                               | 58                | 0                            | (1 )                          | 57            |
|  | 151,835           | 283                          | (444 )                        | 151,674       |
|  | \$ 154,183        | 406                          | (444 )                        | 154,145       |

| <i>(Dollars in thousands)</i>      | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>December 31, 2014:</u>          |                   |                              |                               |               |
| Mortgage-backed securities:        |                   |                              |                               |               |
| FHLMC                              | \$ 1,418          | 90                           | 0                             | 1,508         |
| FNMA                               | 1,337             | 64                           | 0                             | 1,401         |
|                                    | 2,755             | 154                          | 0                             | 2,909         |
| Other marketable securities:       |                   |                              |                               |               |
| U.S. Government agency obligations | 135,014           | 31                           | (601 )                        | 134,444       |
| Corporate preferred stock          | 700               | 0                            | (280 )                        | 420           |
| Corporate equity                   | 58                | 3                            | 0                             | 61            |
|                                    | 135,772           | 34                           | (881 )                        | 134,925       |
|                                    | \$ 138,527        | 188                          | (881 )                        | 137,834       |

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The following table indicates amortized cost and estimated fair value of securities available for sale at March 31, 2015 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

| <i>(Dollars in thousands)</i>          | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Due less than one year                 | \$ 137,052        | 137,275       |
| Due after one year through five years  | 16,373            | 16,463        |
| Due after five years through ten years | 0                 | 0             |
| Due after ten years                    | 700               | 350           |
| No stated maturity                     | 58                | 57            |
| Total                                  | \$ 154,183        | 154,145       |

The allocation of mortgage-backed securities in the table above is based upon the anticipated future cash flow of the securities using estimated mortgage prepayment speeds. The allocation of other marketable securities that have call features is based on the anticipated cash flows to the call date if it is anticipated that the security will be called, or to the maturity date if it is not anticipated to be called.

**(8) Loans Receivable, Net**

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A summary of loans receivable at March 31, 2015 and December 31, 2014 is as follows:

|                               | March<br>31,<br>2015 | December<br>31,<br>2014 |
|-------------------------------|----------------------|-------------------------|
| <i>(Dollars in thousands)</i> |                      |                         |
| 1-4 family                    | \$70,062             | 69,841                  |
| Commercial real estate:       |                      |                         |
| Residential developments      | 19,772               | 19,960                  |
| Other                         | 172,154              | 171,708                 |
|                               | 191,926              | 191,668                 |
| Consumer                      | 52,503               | 54,925                  |
| Commercial business:          |                      |                         |
| Construction industry         | 5,102                | 7,121                   |
| Other                         | 49,253               | 50,001                  |
|                               | 54,355               | 57,122                  |
| Total loans                   | 368,846              | 373,556                 |
| Less:                         |                      |                         |
| Unamortized discounts         | 13                   | 14                      |
| Net deferred loan fees        | 45                   | 97                      |
| Allowance for loan losses     | 8,418                | 8,332                   |
| Total loans receivable, net   | \$360,370            | 365,113                 |



**(9) Allowance for Loan Losses and Credit Quality Information**

The allowance for loan losses is summarized as follows:

| <i>(Dollars in thousands)</i> | 1-4<br>Family | Commercial<br>Real Estate | Consumer | Commercial<br>Business | Total    |
|-------------------------------|---------------|---------------------------|----------|------------------------|----------|
| Balance, December 31, 2014    | \$1,096       | 5,024                     | 1,009    | 1,203                  | 8,332    |
| Provision for losses          | (5 )          | 34                        | 23       | (52 )                  | 0        |
| Charge-offs                   | 0             | 0                         | (18 )    | 0                      | (18 )    |
| Recoveries                    | 0             | 64                        | 8        | 32                     | 104      |
| Balance, March 31, 2015       | \$1,091       | 5,122                     | 1,022    | 1,183                  | 8,418    |
| Balance, December 31, 2013    | \$1,628       | 6,458                     | 1,106    | 2,209                  | 11,401   |
| Provision for losses          | 84            | (1,194 )                  | 101      | (601 )                 | (1,610 ) |
| Charge-offs                   | 0             | (935 )                    | (31 )    | (1 )                   | (967 )   |
| Recoveries                    | 0             | 214                       | 10       | 42                     | 266      |
| Balance, March 31, 2014       | \$1,712       | 4,543                     | 1,186    | 1,649                  | 9,090    |
| Allocated to:                 |               |                           |          |                        |          |
| Specific reserves             | \$270         | 370                       | 307      | 127                    | 1,074    |
| General reserves              | 826           | 4,654                     | 702      | 1,076                  | 7,258    |
| Balance, December 31, 2014    | \$1,096       | 5,024                     | 1,009    | 1,203                  | 8,332    |
| Allocated to:                 |               |                           |          |                        |          |
| Specific reserves             | \$280         | 226                       | 299      | 124                    | 929      |
| General reserves              | 811           | 4,896                     | 723      | 1,059                  | 7,489    |
| Balance, March 31, 2015       | \$1,091       | 5,122                     | 1,022    | 1,183                  | 8,418    |

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Loans receivable at December 31, 2014:

|                                      |          |         |        |        |         |
|--------------------------------------|----------|---------|--------|--------|---------|
| Individually reviewed for impairment | \$ 1,867 | 9,728   | 806    | 555    | 12,956  |
| Collectively reviewed for impairment | 67,974   | 181,940 | 54,119 | 56,567 | 360,600 |
| Ending balance                       | \$69,841 | 191,668 | 54,925 | 57,122 | 373,556 |

Loans receivable at March 31, 2015:

|                                      |          |         |        |        |         |
|--------------------------------------|----------|---------|--------|--------|---------|
| Individually reviewed for impairment | \$ 1,960 | 8,664   | 601    | 515    | 11,740  |
| Collectively reviewed for impairment | 68,102   | 183,262 | 51,902 | 53,840 | 357,106 |
| Ending balance                       | \$70,062 | 191,926 | 52,503 | 54,355 | 368,846 |

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The following table summarizes the amount of classified and unclassified loans at March 31, 2015 and December 31, 2014:

| <i>(Dollars in thousands)</i> | March 31, 2015                   |             |          |      |        | Unclassified |                |
|-------------------------------|----------------------------------|-------------|----------|------|--------|--------------|----------------|
|                               | Classified<br>Special<br>Mention | Substandard | Doubtful | Loss | Total  | Total        | Total<br>Loans |
| 1-4 family                    | \$0                              | 2,667       | 59       | 0    | 2,726  | 67,336       | 70,062         |
| Commercial real estate:       |                                  |             |          |      |        |              |                |
| Residential developments      | 360                              | 8,720       | 0        | 0    | 9,080  | 10,692       | 19,772         |
| Other                         | 4,954                            | 10,663      | 0        | 0    | 15,617 | 156,537      | 172,154        |
| Consumer                      | 0                                | 291         | 54       | 256  | 601    | 51,902       | 52,503         |
| Commercial business:          |                                  |             |          |      |        |              |                |
| Construction industry         | 0                                | 387         | 28       | 0    | 415    | 4,687        | 5,102          |
| Other                         | 5,300                            | 1,082       | 0        | 0    | 6,382  | 42,871       | 49,253         |
|                               | \$10,614                         | 23,810      | 141      | 256  | 34,821 | 334,025      | 368,846        |

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| <i>(Dollars in thousands)</i> | December 31, 2014                |             |          |      |        | Unclassified |                |
|-------------------------------|----------------------------------|-------------|----------|------|--------|--------------|----------------|
|                               | Classified<br>Special<br>Mention | Substandard | Doubtful | Loss | Total  | Total        | Total<br>Loans |
| 1-4 family                    | \$0                              | 2,493       | 207      | 0    | 2,700  | 67,141       | 69,841         |
| Commercial real estate:       |                                  |             |          |      |        |              |                |
| Residential developments      | 323                              | 9,960       | 0        | 0    | 10,283 | 9,677        | 19,960         |
| Other                         | 7,376                            | 8,792       | 0        | 0    | 16,168 | 155,540      | 171,708        |
| Consumer                      | 0                                | 489         | 55       | 261  | 805    | 54,120       | 54,925         |

## Commercial business:

|                       |          |        |     |     |        |         |         |
|-----------------------|----------|--------|-----|-----|--------|---------|---------|
| Construction industry | 0        | 439    | 0   | 0   | 439    | 6,682   | 7,121   |
| Other                 | 4,255    | 1,156  | 0   | 0   | 5,411  | 44,590  | 50,001  |
|                       | \$11,954 | 23,329 | 262 | 261 | 35,806 | 337,750 | 373,556 |

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Classified loans represent special mention, substandard (performing and non-performing), and non-performing loans categorized as doubtful and loss. Loans classified as special mention are loans that have potential weaknesses that, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Loans classified as substandard are loans that are generally inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loans classified as doubtful have the weaknesses of those classified as substandard, with additional characteristics that make collection in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. A loan classified as loss is considered uncollectible and of such little value that continuance as an asset on the balance sheet is not warranted. Loans classified as substandard or doubtful require the Bank to perform an analysis of the individual loan and charge off any loans, or portion thereof, that are deemed uncollectible.

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The aging of past due loans at March 31, 2015 and December 31, 2014 are summarized as follows:

| <i>(Dollars in thousands)</i> | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90<br>Days<br>or<br>More<br>Past<br>Due | Total<br>Past<br>Due | Current<br>Loans | Total<br>Loans | Loans 90<br>Days or<br>More<br>Past Due<br>and Still<br>Accruing |
|-------------------------------|------------------------------|------------------------------|---|----------------------|------------------|----------------|--|
| <i>March 31, 2015</i>         |                              |                              |   |                      |                  |                |  |
| 1-4 family                    | \$1,611                      | 0                            | 270                                     | 1,881                | 68,181           | 70,062         | 0  |
| Commercial real estate:       |                              |                              |   |                      |                  |                |  |
| Residential developments      | 0                            | 0                            | 0                                       | 0                    | 19,772           | 19,772         | 0  |
| Other                         | 0                            | 0                            | 0                                       | 0                    | 172,154          | 172,154        | 0  |
| Consumer                      | 415                          | 70                           | 124                                     | 609                  | 51,894           | 52,503         | 0  |
| Commercial business:          |                              |                              |   |                      |                  |                |  |
| Construction industry         | 28                           | 0                            | 0                                       | 28                   | 5,074            | 5,102          | 0  |
| Other                         | 127                          | 0                            | 0                                       | 127                  | 49,126           | 49,253         | 0  |
|                               | \$2,181                      | 70                           | 394                                     | 2,645                | 366,201          | 368,846        | 0  |
| <i>December 31, 2014</i>      |                              |                              |   |                      |                  |                |  |
| 1-4 family                    | \$413                        | 673                          | 841                                     | 1,927                | 67,914           | 69,841         | 0  |
| Commercial real estate:       |                              |                              |   |                      |                  |                |  |
| Residential developments      | 0                            | 0                            | 0                                       | 0                    | 19,960           | 19,960         | 0  |
| Other                         | 0                            | 0                            | 0                                       | 0                    | 171,708          | 171,708        | 0  |
| Consumer                      | 550                          | 176                          | 131                                     | 857                  | 54,068           | 54,925         | 0  |
| Commercial business:          |                              |                              |   |                      |                  |                |  |
|                               | 0                            | 0                            | 0                                       | 0                    | 7,121            | 7,121          | 0  |

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Construction industry

|       |         |     |     |       |         |         |   |
|-------|---------|-----|-----|-------|---------|---------|---|
| Other | 136     | 0   | 0   | 136   | 49,865  | 50,001  | 0 |
|       | \$1,099 | 849 | 972 | 2,920 | 370,636 | 373,556 | 0 |

Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled debt restructuring (TDR). The following table summarizes impaired loans and related allowances as of March 31, 2015 and December 31, 2014:

| <i>(Dollars in thousands)</i>             | March 31, 2015      |                          |                   | December 31, 2014   |                          |                   |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Loans with no related allowance recorded: |                     |                          |                   |                     |                          |                   |
| 1-4 family                                | \$732               | 732                      | 0                 | 755                 | 755                      | 0                 |
| Commercial real estate:                   |                     |                          |                   |                     |                          |                   |
| Residential developments                  | 6,738               | 9,361                    | 0                 | 7,416               | 10,040                   | 0                 |
| Other                                     | 502                 | 664                      | 0                 | 48                  | 216                      | 0                 |
| Consumer                                  | 270                 | 271                      | 0                 | 463                 | 464                      | 0                 |
| Commercial business:                      |                     |                          |                   |                     |                          |                   |
| Construction industry                     | 56                  | 174                      | 0                 | 80                  | 198                      | 0                 |
| Other                                     | 0                   | 0                        | 0                 | 0                   | 0                        | 0                 |
| Loans with an allowance recorded:         |                     |                          |                   |                     |                          |                   |
| 1-4 family                                | 1,228               | 1,228                    | 280               | 1,112               | 1,112                    | 270               |
| Commercial real estate:                   |                     |                          |                   |                     |                          |                   |
| Residential developments                  | 1,228               | 1,228                    | 195               | 1,522               | 1,522                    | 240               |

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|                          |          |        |     |        |        |       |
|--------------------------|----------|--------|-----|--------|--------|-------|
| Other                    | 196      | 197    | 31  | 742    | 743    | 130   |
| Consumer                 | 331      | 347    | 299 | 343    | 360    | 307   |
| Commercial business:     |          |        |     |        |        |       |
| Construction industry    | 0        | 0      | 0   | 0      | 0      | 0     |
| Other                    | 459      | 1,011  | 124 | 475    | 1,026  | 127   |
| Total:                   |          |        |     |        |        |       |
| 1-4 family               | 1,960    | 1,960  | 280 | 1,867  | 1,867  | 270   |
| Commercial real estate:  |          |        |     |        |        |       |
| Residential developments | 7,966    | 10,589 | 195 | 8,938  | 11,562 | 240   |
| Other                    | 698      | 861    | 31  | 790    | 959    | 130   |
| Consumer                 | 601      | 618    | 299 | 806    | 824    | 307   |
| Commercial business:     |          |        |     |        |        |       |
| Construction industry    | 56       | 174    | 0   | 80     | 198    | 0     |
| Other                    | 459      | 1,011  | 124 | 475    | 1,026  | 127   |
|                          | \$11,740 | 15,213 | 929 | 12,956 | 16,436 | 1,074 |

The following table summarizes the average recorded investment and interest income recognized on impaired loans during the three months ended March 31, 2015 and 2014:

| <i>(Dollars in thousands)</i>             | March 31, 2015                    |                                  | March 31, 2014                    |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| Loans with no related allowance recorded: |                                   |                                  |                                   |                                  |
| 1-4 family                                | \$744                             | 3                                | 469                               | 4                                |
| Commercial real estate:                   |                                   |                                  |                                   |                                  |
| Residential developments                  | 7,077                             | 94                               | 7,685                             | 13                               |
| Other                                     | 275                               | 8                                | 52                                | 0                                |
| Consumer                                  | 367                               | 0                                | 479                               | 2                                |
| Commercial business:                      |                                   |                                  |                                   |                                  |
| Construction/development                  | 68                                | 0                                | 92                                | 0                                |
| Other                                     | 0                                 | 0                                | 0                                 | 0                                |
| Loans with an allowance recorded:         |                                   |                                  |                                   |                                  |
| 1-4 family                                | 1,170                             | 22                               | 1,696                             | 15                               |
| Commercial real estate:                   |                                   |                                  |                                   |                                  |
| Residential developments                  | 1,375                             | 7                                | 5,890                             | 13                               |
| Other                                     | 469                               | 0                                | 882                               | 8                                |
| Consumer                                  | 337                               | 2                                | 469                               | 2                                |
| Commercial business:                      |                                   |                                  |                                   |                                  |
| Construction/development                  | 0                                 | 0                                | 0                                 | 0                                |
| Other                                     | 467                               | 5                                | 998                               | 8                                |



|                          |          |     |        |    |
|--------------------------|----------|-----|--------|----|
| Total:                   |          |     |        |    |
| 1-4 family               | 1,914    | 25  | 2,165  | 19 |
| Commercial real estate:  |          |     |        |    |
| Residential developments | 8,452    | 101 | 13,575 | 26 |
| Other                    | 744      | 8   | 934    | 8  |
| Consumer                 | 704      | 2   | 948    | 4  |
| Commercial business:     |          |     |        |    |
| Construction/development | 68       | 0   | 92     | 0  |
| Other                    | 467      | 5   | 998    | 8  |
|                          | \$12,349 | 141 | 18,712 | 65 |

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At March 31, 2015 and December 31, 2014, non-accruing loans totaled \$10.0 million and \$10.9 million, respectively, for which the related allowance for loan losses was \$0.7 million and \$0.8 million, respectively. The decrease in the allowances related primarily to several commercial real estate construction loans to the same borrower that were paid off during the first quarter of 2015. All of the interest income that was recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which no specific allowance has been recorded, because management determined that the value of the collateral was sufficient to repay the loan totaled \$7.8 million and \$8.0 million, at March 31, 2015 and December 31, 2014, respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

The non-accrual loans at March 31, 2015 and December 31, 2014 are summarized as follows:

| <i>(Dollars in thousands)</i> | March<br>31,<br>2015 | December<br>31, 2014 |
|-------------------------------|----------------------|----------------------|
| 1-4 family                    | \$1,658              | \$ 1,564             |
| Commercial real estate:       |                      |                      |
| Residential developments      | 7,448                | 8,483                |
| Other                         | 244                  | 267                  |
| Consumer                      | 542                  | 486                  |
| Commercial business:          |                      |                      |
| Construction/development      | 56                   | 80                   |
| Other                         | 41                   | 40                   |
|                               | \$9,989              | \$ 10,920            |

At March 31, 2015 and December 31, 2014, there were loans included in loans receivable, net, with terms that had been modified in a TDR totaling \$8.9 million and \$9.4 million, respectively. There was one \$9,000 loan modified in the first quarter of 2015 that is classified and non-performing at March 31, 2015.

The following table summarizes troubled debt restructurings at March 31, 2015 and December 31, 2014:

| <i>(Dollars in thousands)</i> | March 31, 2015 |             |       | December, 31, 2014 |             |       |
|-------------------------------|----------------|-------------|-------|--------------------|-------------|-------|
|                               | Accruing       | Non-Accrual | Total | Accruing           | Non-Accrual | Total |
| 1-4 Family                    | \$302          | 62          | 364   | 303                | 65          | 368   |
| Commercial real estate        | 972            | 6,738       | 7,710 | 979                | 6,977       | 7,956 |
| Consumer                      | 59             | 240         | 299   | 320                | 251         | 571   |
| Commercial business           | 419            | 92          | 511   | 434                | 121         | 555   |
|                               | \$1,752        | 7,132       | 8,884 | 2,036              | 7,414       | 9,450 |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as non-accrual at March 31, 2015 or December 31, 2014.

TDR concessions can include reduction of interest rates, extension of maturity dates, forgiveness of principal and/or interest due, or acceptance of real estate or other assets in full or partial satisfaction of the debt. Loan modifications are not reported as TDRs after 12 months if the loan was modified at a market rate of interest for comparable risk loans, and the loan is performing in accordance with the terms of the restructured agreement for the entire 12-month period. All loans classified as TDRs are considered to be impaired.

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the consolidated balance sheets, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following table and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the three-months ended March 31, 2015 and March 31, 2014.

| <i>(Dollars in thousands)</i> | Three Months Ended   |  | Three Months Ended   |  |
|-------------------------------|--|--|--|--|
|                               | March 31, 2015   |  | March 31, 2014   |  |
|                               | Pre-Modification<br>Number<br>of<br>Contracts<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Pre-Modification<br>Number<br>of<br>Contracts<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Troubled debt restructurings: |  |  |  |  |
| Consumer                      | 1 \$ 9   | 9  | 2 \$ 93  | \$ 94  |

There were no loans that were restructured within the 12 months preceding March 31, 2015 and March 31, 2014 that defaulted during the three months ended March 31, 2015 and March 31, 2014.

The Company considers a loan to have defaulted when it becomes 90 or more days past due under the modified terms, when it is placed in non-accrual status, when it becomes other real estate owned, or when it becomes non-compliant with some other material requirement of the modification agreement.

Loans that were non-accrual prior to modification remain on non-accrual status for at least six months following modification. Non-accrual TDR loans that have performed according to the modified terms for six months may be returned to accrual status. Loans that were accruing prior to modification remain on accrual status after the modification as long as the loan continues to perform under the new terms.

TDRs are reviewed for impairment following the same methodology as other impaired loans. For loans that are collateral-dependent, the value of the collateral is reviewed and additional reserves may be added as needed. Loans that are not collateral-dependent may have additional reserves established if deemed necessary. The reserves for TDRs were \$0.4 million, or 4.6%, of the total \$8.4 million in loan loss reserves at March 31, 2015 and \$0.4 million, or 5.1%, of the total \$8.3 million in loan loss reserves at December 31, 2014.

#### **(10) Investment in Mortgage Servicing Rights**

A summary of mortgage servicing activity is as follows:

|   | Three<br>Months<br>ended | Twelve<br>Months<br>ended | Three<br>Months<br>ended |
|---|--------------------------|---------------------------|--------------------------|
| <i>(Dollars in thousands)</i>           | March<br>31,<br>2015     | December<br>31, 2014      | March<br>31,<br>2014     |
| Balance, beginning of period            | \$ 1,507                 | 1,708                     | 1,708                    |
| Originations                            | 84                       | 316                       | 38                       |
| Amortization                            | (143 )                   | (517 )                    | (116 )                   |
| Balance, end of period                  | \$ 1,448                 | 1,507                     | 1,630                    |
| Fair value of mortgage servicing rights | \$ 2,508                 | 2,562                     | 2,739                    |

All of the loans being serviced were single family loans under the FNMA individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at March 31, 2015.

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|                                  | Loan<br>Principal<br>Balance | Weighted<br>Average<br>Interest<br>Rate | Weighted<br>Average<br>Remaining<br>Term<br>(months) | Number<br>of<br>Loans |
|----------------------------------|------------------------------|---|--|-----------------------|
| <i>(Dollars in thousands)</i>    |                              |   |  |                       |
| Original term 30 year fixed rate | \$203,872                    | 4.28                                    | % 298  | 1,765                 |
| Original term 15 year fixed rate | 110,145                      | 3.30                                    | 140  | 1,238                 |
| Adjustable rate                  | 60                           | 4.38                                    | 314  | 2                     |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at March 31, 2015 is presented in the following table. Amortization expense for mortgage servicing rights was \$143,000 and \$116,000 for the three months ended March 31, 2015 and 2014, respectively.

|                               | March 31, 2015              |                             |   | Unamortized                     |
|-------------------------------|-----------------------------|-----------------------------|---|---------------------------------|
|                               | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |   | Mortgage<br>Servicing<br>Rights |
| <i>(Dollars in thousands)</i> |                             |                             |   |                                 |
| Mortgage servicing rights     | \$3,587                     | (2,139)                     | ) | 1,448                           |
| Total                         | \$3,587                     | (2,139)                     | ) | 1,448                           |

|                               | March 31, 2014              |                             |   | Unamortized                     |
|-------------------------------|-----------------------------|-----------------------------|---|---------------------------------|
|                               | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |   | Mortgage<br>Servicing<br>Rights |
| <i>(Dollars in thousands)</i> |                             |                             |   |                                 |
| Mortgage servicing rights     | \$3,621                     | (1,991)                     | ) | 1,630                           |
| Total                         | \$3,621                     | (1,991)                     | ) | 1,630                           |

The following table indicates the estimated future amortization expense for mortgage servicing rights:

*(Dollars in thousands)*

|                          |         |
|--------------------------|---------|
| Year ending December 31, |         |
| 2015                     | \$ 320  |
| 2016                     | 388     |
| 2017                     | 305     |
| 2018                     | 208     |
| 2019                     | 142     |
| Thereafter               | 85      |
| Total                    | \$1,448 |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of March 31, 2015. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

### **(11) Earnings per Common Share**

The following table reconciles the weighted average shares outstanding and the earnings available to common shareholders used for basic and diluted earnings per common share:

|  |                                 |           |
|--|---------------------------------|-----------|
|  | Three months ended<br>March 31, |           |
|  | 2015                            | 2014      |
| <i>(Dollars in thousands, except per share data)</i>   |                                 |           |
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 4,096,985                       | 4,038,817 |
| Net dilutive effect of:  |                                 |           |
| Restricted stock awards and warrant  | 574,665                         | 548,527   |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities                 | 4,671,650                       | 4,587,344 |
| Income available to common shareholders  | \$ 353                          | 1,100     |
| Basic earnings per common share  | \$ 0.09                         | 0.27      |
| Diluted earnings per common share  | \$ 0.08                         | 0.24      |

### **(12) Regulatory Capital and Oversight**

Effective January 1, 2015 the capital requirements of the Company and the Bank were changed to implement the regulatory requirements of the Basel III capital reforms. The new requirements, among other things, (i) apply a strengthened set of capital requirements to both the Company and the Bank, including new requirements relating to

common equity as a component of core capital, (ii) implement a “capital conservation buffer” against risk and a higher minimum tier 1 capital requirement, and (iii) revise the rules for calculating risk-weighted assets for purposes of such requirements. The new rules made corresponding revisions to the prompt corrective action framework and include the new capital ratios and buffer requirements which will be phased in incrementally, with full implementation scheduled for January 1, 2019. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, both the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulations to ensure capital adequacy require both the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Common Equity Tier 1 capital to risk weighted assets (as defined in the regulations), Tier 1 capital to adjusted total assets (as defined), Tier 1 capital to risk weighted assets, and total capital to risk weighted assets.

On March 31, 2015, the Bank's average total assets were \$569.0 million, its adjusted total assets were \$565.0 million and its risk-weighted assets were \$420.3 million. The following table presents the Bank's capital amounts and ratios at March 31, 2015 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the revised Prompt Corrective Actions regulations.

|  | Actual   |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective Action Provisions <sup>(1)</sup> |                                  |        |                                  |
|--|----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|--------|----------------------------------|
|  | Amount   | Percent of Assets <sup>(2)</sup> | Amount                                | Percent of Assets <sup>(2)</sup> | Amount         | Percent of Assets <sup>(2)</sup> | Amount  | Percent of Assets <sup>(2)</sup> | Amount | Percent of Assets <sup>(2)</sup> |
| <i>(Dollars in thousands)</i>                                |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Bank stockholder's equity                                    | \$74,718 |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Plus:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Net unrealized loss on certain securities available for sale | 23       |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Less:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Disallowed servicing and tax assets                          | 3,970    |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Common equity tier I capital                                 | 70,771   |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Common equity tier I capital ratio                           |          | 16.84 %                          | \$18,914                              | 4.50 %                           | \$51,857       | 12.34 %                          | \$27,321  | 6.50 %                           |        |                                  |
| Tier I capital   | 70,771   |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Tier I capital to adjusted total assets (leverage ratio)     |          | 12.52 %                          | \$22,602                              | 4.00 %                           | \$48,169       | 8.52 %                           | \$28,252  | 5.00 %                           |        |                                  |
| Tier I capital to risk-weighted assets                       |          | 16.84 %                          | \$25,219                              | 6.00 %                           | \$45,552       | 10.84 %                          | \$33,626  | 8.00 %                           |        |                                  |
| Plus:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Allowable allowance for loan losses                          | 5,293    |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Risk-based capital   | \$76,064 |                                  | \$33,626                              |                                  | \$42,438       |                                  | \$42,032  |                                  |        |                                  |



|  |         |        |         |         |
|--|---------|--------|---------|---------|
| Risk-based capital to risk-weighted assets | 18.10 % | 8.00 % | 10.10 % | 10.00 % |
|--|---------|--------|---------|---------|

(1) Under the recently issued final rules, revised requirements will be phased in commencing January 1, 2015, as described above.

(2) Based upon the Bank's adjusted total assets for the purpose of leverage ratio and risk-weighted assets for the purpose of the risk-based capital ratios.

On March 31, 2015, the Company's average total assets were \$573.2 million, its adjusted total assets were \$568.3 million and its risk-weighted assets were \$420.3 million. The following table presents the Company's capital amounts and ratios at March 31, 2015 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the revised Prompt Corrective Actions regulations.

|  | Actual   |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective Action Provisions <sup>(1)</sup> |                                  |        |                                  |
|--|----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|---|----------------------------------|--------|----------------------------------|
|  | Amount   | Percent of Assets <sup>(2)</sup> | Amount                                | Percent of Assets <sup>(2)</sup> | Amount         | Percent of Assets <sup>(2)</sup> | Amount  | Percent of Assets <sup>(2)</sup> | Amount | Percent of Assets <sup>(2)</sup> |
| <i>(Dollars in thousands)</i>                                |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Company stockholder's equity                                 | \$66,775 |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Plus:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Net unrealized loss on certain securities available for sale | 23       |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Less:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Disallowed servicing and tax assets                          | 4,893    |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Common equity tier I capital                                 | 61,905   |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Common equity tier I capital ratio                           |          | 14.73 %                          | \$18,912                              | 4.50 %                           | \$42,994       | 10.23 %                          | \$27,318  | 6.50 %                           |        |                                  |
| Tier I capital   | 61,905   |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Tier I capital to adjusted total assets (leverage ratio)     |          | 10.89 %                          | \$22,731                              | 4.00 %                           | \$39,175       | 6.89 %                           | \$28,414  | 5.00 %                           |        |                                  |
| Tier I capital to risk-weighted assets                       |          | 14.73 %                          | \$25,217                              | 6.00 %                           | \$36,689       | 8.73 %                           | \$33,622  | 8.00 %                           |        |                                  |
| Plus:  |          |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Allowable allowance for loan losses                          | 5,293    |                                  |                                       |                                  |                |                                  |   |                                  |        |                                  |
| Risk-based capital   | \$67,198 |                                  | \$33,622                              |                                  | \$33,576       |                                  | \$42,028  |                                  |        |                                  |
| Risk-based capital to risk-weighted assets                   |          | 15.99 %                          |                                       | 8.00 %                           |                | 7.99 %                           |   | 10.00 %                          |        |                                  |

(1) Under the recently issued final rules, revised requirements will be phased in commencing January 1, 2015, as described above.

(2) Based upon the Company's adjusted total assets for the purpose of leverage ratio and risk-weighted assets for the purpose of the risk-based capital ratios.

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Management believes that, as of March 31, 2015, both the Company's and the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the current prompt corrective action regulations described above. However, there can be no assurance that the Company or the Bank will continue to maintain such status in the future. Regulators have extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be "well-capitalized" in the future.

### **(13) Preferred Stock**

The Company's certificate of incorporation authorizes the issuance of up to 500,000 shares of preferred stock, and on December 23, 2008, the Company completed the sale of 26,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) to the United States Treasury. The Preferred Stock has a liquidation value of \$1,000 per share and a related warrant was also issued to purchase 833,333 shares of HMN common stock at an exercise price of \$4.68 per share. The transaction was part of the United States Treasury's Capital Purchase Program under the Emergency Economic Stabilization Act of 2008.

In 2014 the Company redeemed 16,000 shares of Preferred Stock. On February 17, 2015, the Company redeemed the remaining 10,000 shares of outstanding Preferred Stock. After giving effect to a dividend of \$22.50 per share on the Preferred Stock that was paid on the same date, the redemption price per share was \$1,000. The Preferred Stock dividend was funded by HMN through internally available funds.

Treasury continues to hold the warrant to purchase 833,333 shares of the Company's common stock at an exercise price of \$4.68, which Treasury may sell in its discretion at any time, subject to applicable securities laws and the Company's right to repurchase the warrant at fair market value under the terms of the Company's agreements with Treasury. The warrant may be exercised at any time over its ten-year term, which expires on December 23, 2018, and Treasury has agreed not to exercise any voting rights received by acquiring common stock on the exercise of the warrant.

### **(14) Other Borrowings**

The Company funded the Preferred Stock redemption on February 17, 2015 with a \$10 million term loan to HMN from an unrelated third party that was evidenced by a promissory note. The principal balance of the note bears interest at a rate of 6.5% and is payable in consecutive annual installments of \$1 million on each December 15, beginning December 15, 2015, with the balance due on December 15, 2021.



**(15) Commitments and Contingencies**

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at March 31, 2015 were approximately \$1.6 million, expire over the next 15 months, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

**(16) Business Segments**

The Bank has been identified as a reportable operating segment in accordance with the provisions of ASC 280. HMN did not meet the quantitative thresholds for determining reportable segments and, therefore, is included in the "Other" category.

The Company evaluates performance and allocates resources based on the segment's net income, return on average assets and equity. Each corporation is managed separately with its own officers and board of directors, some of whom may overlap between the corporations.

The following table sets forth certain information about the reconciliations of reported profit and assets for each of the Company's reportable segments.

| <i>(Dollars in thousands)</i>                      | Home Federal |        |              | Consolidated |
|--|--------------|--------|--------------|--------------|
|  | Savings Bank | Other  | Eliminations | Total        |
| <b>At or for the quarter ended March 31, 2015:</b> |              |        |              |              |
| Interest income - external customers               | \$4,884      | 0      | 0            | 4,884        |
| Non-interest income - external customers           | 1,596        | 0      | 0            | 1,596        |
| Intersegment non-interest income                   | 51           | 591    | (642 )       | 0            |
| Interest expense                                   | 248          | 78     | 0            | 326          |
| Non-interest expense                               | 5,305        | 179    | (51 )        | 5,433        |
|  | 387          | (127 ) | 0            | 260          |

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Income tax expense (benefit)

|              |         |        |           |         |
|--------------|---------|--------|-----------|---------|
| Net income   | 591     | 461    | (591 )    | 461     |
| Total assets | 564,427 | 76,760 | (75,700 ) | 565,487 |

**At or for the quarter ended March 31, 2014:**

|  |         |        |           |         |
|--|---------|--------|-----------|---------|
| Interest income - external customers     | \$5,427 | 0      | 0         | 5,427   |
| Non-interest income - external customers | 1,688   | 0      | 0         | 1,688   |
| Intersegment non-interest income         | 45      | 1,714  | (1,759 )  | 0       |
| Interest expense                         | 334     | 0      | 0         | 334     |
| Non-interest expense                     | 5,534   | 208    | (45 )     | 5,697   |
| Income tax expense (benefit)             | 1,188   | (126 ) | 0         | 1,062   |
| Net income                               | 1,714   | 1,632  | (1,714 )  | 1,632   |
| Total assets                             | 619,809 | 92,262 | (91,296 ) | 620,775 |

**HMN FINANCIAL, INC.**

**Item 2: MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Forward-looking Information*

Safe Harbor Statement

This quarterly report and other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as “expect,” “intend,” “look,” “believe,” “anticipate,” “estimate,” “project,” “seek,” “may,” “will,” “would,” “could,” “should,” “trend,” “ta similar statements or variations of such terms and include, but are not limited to, those relating to increasing our core deposit relationships, improving credit quality, reducing non-performing assets, reducing expense and generating improved financial results; the adequacy and amount of available liquidity and capital resources to the Bank; the Company’s liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for improvement thereof; improvements in loan production; changes in the size of the Bank’s loan portfolio; the amount of the Bank’s non-performing assets and the appropriateness of the allowance therefor; our ability to complete the acquisition of assets of Kasson State Bank and integrate its operations; anticipated future levels of the provision for loan losses; future losses on non-performing assets; the amount and mix of interest-earning assets; the amount and mix of deposits; the availability of alternate funding sources; the payment of dividends by HMN, the future outlook for the Company; the amount of dividends paid by the FHLB on its stock; the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced; the projected changes in net interest income based on rate shocks; the range that interest rates may fluctuate over the next twelve months; the net market risk of interest rate shocks; the future outlook for the issuer of the trust preferred securities held by the Bank; the ability of the Bank to pay dividends to HMN; the ability of HMN to pay the principal and interest payments on its third party note payable; the ability to remain well capitalized under revised capital rules; and compliance by the Company and the Bank with regulatory standards generally (including the Bank’s status as “well-capitalized”) and other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically, and possible responses of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), the Bank, and the Company to any failure to comply with any such regulatory standard, directive or requirement.

A number of factors could cause actual results to differ materially from the Company’s assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement; possible legislative and regulatory changes, including additional changes to regulatory capital rules; the ability of the Bank to comply with other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard or requirement; adverse economic, business and competitive developments such as

shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company's loan and investment portfolios, changes in costs associated with alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank, technological, computer-related or operational difficulties, results of litigation, and reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company's access to and adverse changes in securities markets; the market for credit related assets; the future operating results, financial condition, cash flow requirements and capital spending priorities of the Company and the Bank; the availability of internal and, as required, external sources of funding; acquisition integration costs; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the Company's most recent filings on Forms 10-K and 10-Q with the Securities and Exchange Commission. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements. For additional discussion of the risks and uncertainties applicable to the Company, see the "Risk Factors" sections of the Company's Annual Report on Form 10-K for the year ended December 31, 2014 and Part II, Item 1A of its subsequently filed Quarterly Reports on Form 10-Q.



All statements in this quarterly report on Form 10-Q, including forward-looking statements, speak only as of the date hereof, and we undertake no duty to update any of the forward-looking statements after the date of this quarterly report on Form 10-Q.

### *General*

The earnings of the Company are primarily dependent on the Bank's net interest income, which is the difference between interest earned on loans and investments, and the interest paid on interest-bearing liabilities such as deposits and other borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the "interest rate spread." Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses, and amortization of mortgage servicing assets. The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

Between 2008 and 2011, the Company's commercial business and commercial real estate loan portfolios required significant charge-offs due primarily to decreases in the estimated value of the underlying collateral supporting the loans, as many of these loans were made to borrowers in or associated with the real estate industry. The decrease in the estimated collateral value was primarily the result of reduced demand for real estate, particularly as it related to single-family and commercial land developments. More stringent lending standards implemented by the mortgage industry in these years made it more difficult for some borrowers with marginal credit to qualify for a mortgage. This decrease in available credit and the overall weakness in the economy reduced the demand for single family homes and the values of existing properties and developments where the Company's commercial loan portfolio had concentrations. Consequently, our level of non-performing assets and the related provision for loan losses increased significantly during these years, relative to prior periods. The increased levels of non-performing assets, related provisions for loan losses and loan charge-offs, expenses associated with real estate owned, and the valuation allowance established against deferred taxes arising from the adverse operating results, were the primary reasons for the net losses incurred by the Company in each of the years 2008 through 2011. Beginning in 2012 and continuing into 2014, commercial real estate values stabilized, the economy improved, and fewer charge-offs were recorded than in the corresponding periods prior to 2012. In addition, non-performing assets and expenses associated with real estate owned have continued to decline in the first quarter of 2015, which had a positive effect on earnings.

### *Critical Accounting Estimates*

Critical accounting policies are those policies that the Company's management believes are the most important to understanding the Company's financial condition and operating results. These critical accounting policies often involve estimates and assumptions that could have a material impact on the Company's financial statements. The Company has identified the following critical accounting policies that management believes involve the most difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates, assumptions and other factors used.

### *Allowance for Loan Losses and Related Provision*

The allowance for loan losses is based on periodic analysis of the loan portfolio. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan portfolio composition, loan delinquencies, local economic growth rates, historical experience and observations made by the Company's ongoing internal audit and regulatory exam processes. Loans are charged off to the extent they are deemed to be uncollectible. The Company has established separate processes to determine the appropriateness of the loan loss allowance for its homogeneous single-family and consumer loan portfolios and its non-homogeneous loan portfolios. The determination of the allowance on the homogeneous single-family and consumer loan portfolios is calculated on a pooled basis with individual determination of the allowance of all non-performing loans. The determination of the allowance for the non-homogeneous commercial, commercial real estate, and multi-family loan portfolios involves assigning standardized risk ratings and loss factors that are periodically reviewed. The loss factors are estimated based on the Company's own loss experience and are assigned to all loans without identified credit weaknesses. For each non-performing loan, the Company also performs an individual analysis of impairment that is based on the expected cash flows or the value of the assets collateralizing the loans and establishes any necessary reserves or charges off all loans or portion thereof that are deemed uncollectable.

The appropriateness of the allowance for loan losses is dependent upon management's estimates of variables affecting valuation, appraisals of collateral, evaluations of performance and status, and the amounts and timing of future cash flows expected to be received on impaired loans. Such estimates, appraisals, evaluations and cash flows may be subject to frequent adjustments due to changing economic prospects of borrowers or properties. The estimates are reviewed periodically and adjustments, if any, are recorded in the provision for loan losses in the periods in which the adjustments become known. Because of the size of some loans, changes in estimates can have a significant impact on the loan loss provision. The allowance is allocated to individual loan categories based upon the relative risk characteristics of the loan portfolios and the actual loss experience. The Company increases and decreases its allowance for loan losses by charging or crediting the provision for loan losses against income. The methodology for establishing the allowance for loan losses takes into consideration probable losses that have been identified in connection with specific loans as well as probable losses in the loan portfolio for which additional specific reserves are not required. Although management believes that based on current conditions the allowance for loan losses is maintained at an appropriate amount to provide for probable loan losses inherent in the portfolio as of the balance sheet date, future conditions may differ substantially from those anticipated in determining the allowance for loan losses and adjustments may be required in the future.

### *Income Taxes*

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal and state income tax laws and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates

and interpretations used in determining the current and deferred income tax liabilities.

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs are deductible, not the entire provision for loan losses. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is “more likely than not” that the deferred tax asset will not be realized. The determination of whether the deferred tax assets are realizable is highly subjective and dependent upon management’s judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realization of deferred tax assets. Positive evidence includes the Company’s cumulative net income in the prior three year period and the probability that taxable income will be generated in future periods. Negative evidence includes the general business and economic environment. The determination that a valuation reserve was not required at March 31, 2015 was based primarily upon the existence of a three-year cumulative net income and expectations of future taxable income. It is possible that future conditions may differ substantially from those anticipated in determining the valuation allowance on deferred tax assets and adjustments may be required in future periods.

Determining the ultimate settlement of any tax position requires significant estimates and judgments in arriving at the amount of tax benefits to be recognized in the financial statements. It is possible that the tax benefits realized upon the ultimate resolution of a tax position may result in tax benefits that are significantly different from those estimated.

## **RESULTS OF OPERATIONS FOR FIRST QUARTER ENDED MARCH 31, 2015 COMPARED TO FIRST QUARTER ENDED MARCH 31, 2014**

### ***Net Income***

Net income was \$0.5 million for the first quarter of 2015, a decrease of \$1.1 million, compared to net income of \$1.6 million for the first quarter of 2014. Net income available to common shareholders was \$0.4 million for the first quarter of 2015, a decrease of \$0.7 million from the net income available to common shareholders of \$1.1 million for the first quarter of 2014. Diluted earnings per common share for the first quarter of 2015 was \$0.08, a decrease of \$0.16 from diluted earnings per common share of \$0.24 for the first quarter of 2014. The decrease in net income between the periods was due primarily to a \$1.6 million increase in the provision for loan losses because there were fewer commercial loan payoffs and credit rating upgrades in the first quarter of 2015 when compared to the first quarter of 2014. Net income also decreased \$0.5 million because of a decrease in net interest income due to a decrease in the average interest-earning assets between the periods. These reductions in net income were partially offset by a \$0.8 million decrease in income tax expense between the periods due to the decreased income.

### ***Net Interest Income***

Net interest income was \$4.6 million for the first quarter of 2015, a decrease of \$0.5 million, or 10.5%, compared to \$5.1 million for the first quarter of 2014. Interest income was \$4.9 million for the first quarter of 2015, a decrease of \$0.5 million, or 10.0%, from \$5.4 million for the first quarter of 2014. Interest income decreased between the periods primarily because of a decrease in the average yields earned and also because of a \$35 million decrease in the average interest-earning assets between the periods. The decrease in yields was due primarily to decreasing rates on the commercial loan portfolio due to the low interest rate environment that continued to exist in the first quarter of 2015. Average interest-earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of the Company's focus on improving credit quality, reducing loan concentrations, and managing net interest margin. The average yield earned on interest-earning assets was 3.67% for the first quarter of 2015, a decrease of 16 basis points from the 3.83% average yield for the first quarter of 2014.

Interest expense was \$0.3 million for the first quarter of 2015, the same as for the first quarter of 2014. Interest expense remained the same despite the \$25 million decrease in the average interest-bearing liabilities between the periods. The decrease in the average interest bearing liabilities was offset by an increase in interest expense related to the \$10 million holding company note payable that was funded in the first quarter of 2015 in connection with the redemption of the remaining outstanding Preferred Stock. The decrease in the average interest-bearing liabilities is primarily the result of a decrease in the outstanding brokered and retail certificates of deposits between the periods. The decrease in certificates of deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing certificates. Interest expense was also affected by the lower average interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the first quarter of 2015. The average interest rate paid on interest-bearing liabilities was 0.27% for the first quarter of 2015, an increase of 1 basis point from the 0.26% average interest rate paid in the first quarter of 2014.

Net interest margin (net interest income divided by average interest earning assets) for the first quarter of 2015 was 3.42%, a decrease of 17 basis points compared to 3.59% for the first quarter of 2014. Net interest margin decreased between the periods primarily because the yields earned on interest-earning assets decreased more than the rates paid on interest-bearing liabilities. The decrease in the yields earned on interest-earning assets was primarily the result of lower commercial loan yields as a result of the low interest rate environment that continued to exist in the first quarter of 2015.

A summary of the Company's net interest margin for the three-month periods ended March 31, 2015 and 2014 is as follows:

| <i>(Dollars in thousands)</i>  | For the three-month period ended |          |        |                |          |        |
|--|----------------------------------|----------|--------|----------------|----------|--------|
|  | March 31, 2015                   |          |        | March 31, 2014 |          |        |
|  | Average                          | Interest | Yield/ | Average        | Interest | Yield/ |
|  | Outstanding                      | Earned/  | Rate   | Outstanding    | Earned/  | Rate   |
|  | Balance                          | Paid     |        | Balance        | Paid     |        |
| Interest-earning assets:   |                                  |          |        |                |          |        |
| Securities available for sale  | \$146,715                        | 515      | 1.42 % | \$108,872      | 304      | 1.13 % |
| Loans held for sale  | 1,489                            | 8        | 2.09   | 741            | 8        | 4.38   |
| Mortgage loans, net  | 69,545                           | 736      | 4.29   | 75,660         | 804      | 4.31   |
| Commercial loans, net  | 238,932                          | 2,948    | 5.00   | 248,997        | 3,559    | 5.80   |
| Consumer loans, net  | 53,466                           | 661      | 5.02   | 52,961         | 699      | 5.35   |
| Cash equivalents   | 28,998                           | 15       | 0.21   | 87,354         | 52       | 0.24   |
| Federal Home Loan Bank stock   | 774                              | 1        | 0.50   | 784            | 1        | 0.52   |
| Total interest-earning assets  | 539,919                          | 4,884    | 3.67   | 575,369        | 5,427    | 3.83   |
| Interest-bearing liabilities and noninterest bearing deposits:       |                                  |          |        |                |          |        |
| NOW accounts   | 76,997                           | 3        | 0.02   | 70,001         | 4        | 0.02   |
| Savings accounts   | 47,597                           | 7        | 0.06   | 46,077         | 8        | 0.07   |
| Money market accounts  | 149,955                          | 97       | 0.26   | 152,014        | 98       | 0.26   |
| Certificates   | 95,736                           | 141      | 0.60   | 118,498        | 212      | 0.73   |
| Brokered deposits  | 0                                | 0        | 0.00   | 3,365          | 12       | 1.45   |
| Advances and other borrowings  | 4,811                            | 78       | 6.58   | 0              | 0        | 0.00   |
| Total interest-bearing liabilities                                   | 375,096                          |          |        | 389,955        |          |        |
| Non-interest checking  | 115,678                          |          |        | 125,539        |          |        |
| Other non-interest bearing escrow deposits                           | 1,044                            |          |        | 896            |          |        |
| Total interest-bearing liabilities and non-interest bearing deposits | \$491,818                        | 326      | 0.27   | \$516,390      | 334      | 0.26   |
| Net interest income  |                                  | \$4,558  |        |                | \$5,093  |        |
| Net interest rate spread   |                                  |          | 3.40 % |                |          | 3.56 % |
| Net interest margin  |                                  |          | 3.42 % |                |          | 3.59 % |

***Provision for Loan Losses***

The provision for loan losses was \$0 for the first quarter of 2015, an increase of \$1.6 million compared to the \$1.6 million credit provision for loan losses for the first quarter of 2014. The provision increased in the first quarter of 2015 primarily because there were fewer commercial loan payoffs and credit rating upgrades in the first quarter of 2015 when compared to the first quarter of 2014. A reconciliation of the Company's allowance for loan losses for the first quarters of 2015 and 2014 is summarized as follows:



|                               | First Quarter |          |
|-------------------------------|---------------|----------|
| <i>(Dollars in thousands)</i> | 2015          | 2014     |
| Balance at January 1,         | \$8,332       | \$11,401 |
| Provision                     | 0             | (1,610 ) |
| Charge-offs:                  |               |          |
| Consumer                      | (18 )         | (31 )    |
| Commercial business           | 0             | (1 )     |
| Commercial real estate        | 0             | (935 )   |
| Recoveries                    | 104           | 266      |
| Balance at March 31,          | \$8,418       | \$9,090  |
| General allowance             | \$7,489       | \$6,618  |
| Specific allowance            | 929           | 2,472    |
|                               | \$8,418       | \$9,090  |

### ***Non-Interest Income***

Non-interest income was \$1.6 million for the first quarter of 2015, a decrease of \$0.1 million, or 5.45%, from \$1.7 million for the first quarter of 2014. Gain on sales of loans decreased \$61,000 between the periods due to a \$223,000 decrease in the sale of commercial government guaranteed loans that was partially offset by an increase of \$162,000 in the gains recognized on the sale of single family loans. The increase in the gains recognized on single family loans was due to an increase in loan sales between the periods. Fees and service charges decreased \$41,000 between the periods primarily because of a decrease in overdraft fees.

### ***Non-Interest Expense***

Non-interest expense was \$5.4 million for the first quarter of 2015, a decrease of \$0.3 million, or 4.63%, from \$5.7 million for the first quarter of 2014. The gain on real estate owned increased \$180,000 between the periods primarily because of increased real estate sales. Deposit insurance expense decreased \$87,000 between the periods because of a decrease in assets and insurance rates between the periods. Compensation and benefits expense decreased \$30,000 between the periods primarily because of a decrease in wages and defined benefit costs as a result of having fewer employees. Data processing costs decreased \$15,000 due to a decrease in hardware and software depreciation expense between the periods. These decreases in non-interest expense were partially offset by a \$51,000 increase in other non-interest expense between the periods primarily because of increased mortgage servicing rights amortization and advertising expenses.

### ***Income Taxes***

Income tax expense was \$0.3 million for the first quarter of 2015, a decrease of \$0.8 million from \$1.1 million for the first quarter of 2014. The decrease in income tax expense between the periods is primarily related to the decrease in income in the first quarter of 2015 when compared to the first quarter of 2014.

*Net Income Available to Common Shareholders*

The net income available to common shareholders was \$0.4 million for the first quarter of 2015, a decrease of \$0.7 million from the \$1.1 million income available to common shareholders in the first quarter of 2014. The net income available to common shareholders decreased primarily because of the decrease in the net income between the periods that was partially offset by a reduction in the dividends paid on the outstanding Preferred Stock. On February 17, 2015 the Company redeemed the remaining 10,000 shares of its outstanding Preferred Stock after redeeming 10,000 shares in the second quarter of 2014 and 6,000 shares in the fourth quarter of 2014. These redemptions reduced the amount of dividends paid on the Preferred Stock and increased interest expense in the first quarter of 2015 when compared to the first quarter of 2014 as the redemption was funded by a \$10 million holding company note payable to an unrelated third party.

**FINANCIAL CONDITION*****Non-Performing Assets***

The following table summarizes the amounts and categories of non-performing assets in the Bank's portfolio and loan delinquency information as of the end of the two most recently completed quarters.

|  | March<br>31,<br>2015 | December<br>31,<br>2014 |       |   |
|--|----------------------|-------------------------|-------|---|
| <i>(Dollars in thousands)</i>  |                      |                         |       |   |
| Non-Performing Loans:  |                      |                         |       |   |
| One-to-four family real estate   | \$1,658              | \$ 1,564                |       |   |
| Commercial real estate   | 7,692                | 8,750                   |       |   |
| Consumer   | 542                  | 486                     |       |   |
| Commercial business  | 97                   | 120                     |       |   |
| Total  | 9,989                | 10,920                  |       |   |
| Foreclosed and Repossessed Assets:                                       |                      |                         |       |   |
| One-to-four family real estate   | \$50                 | \$ 50                   |       |   |
| Commercial real estate   | 2,916                | 3,053                   |       |   |
| Total non-performing assets  | \$12,955             | \$ 14,023               |       |   |
| Total as a percentage of total assets                                    | 2.29                 | %                       | 2.43  | % |
| Total non-performing loans   | \$9,989              | \$ 10,920               |       |   |
| Total as a percentage of total loans receivable, net                     | 2.77                 | %                       | 2.99  | % |
| Allowance for loan loss to non-performing loans                          | 84.28                | %                       | 76.30 | % |
| Delinquency Data:  |                      |                         |       |   |
| Delinquencies <sup>(1)</sup>   |                      |                         |       |   |
| 30+ days   | \$2,162              | \$ 1,682                |       |   |
| 90+ days   | 0                    | 0                       |       |   |
| Delinquencies as a percentage of Loan and lease portfolio <sup>(1)</sup> |                      |                         |       |   |
| 30+ days   | 0.58                 | %                       | 0.45  | % |
| 90+ days   | 0.00                 | %                       | 0.00  | % |

<sup>(1)</sup> Excludes non-accrual loans.

Total non-performing assets were \$13.0 million at March 31, 2015, a decrease of \$1.0 million, or 7.6%, from \$14.0 million at December 31, 2014. Non-performing loans decreased \$0.9 million and foreclosed and repossessed assets decreased \$0.1 million during the first quarter of 2015.

The non-performing loan and foreclosed and repossessed asset activity for the first quarter of 2015 was as follows:

*(Dollars in thousands)*

| <b>Non-performing loans</b>  |          | <b>Foreclosed and repossessed assets</b> |         |
|------------------------------|----------|--|---------|
| January 1, 2015              | \$10,920 | January 1, 2015                          | \$3,103 |
| Classified as non-performing | 648      | Other payments received on real estate   | (6 )    |
| Charge offs                  | (18 )    | Real estate sold                         | (243 )  |
| Principal payments received  | (1,561 ) | Gain on real estate owned                | 112     |
| Classified as accruing       | 0        | Write downs                              | 0       |
| March 31, 2015               | \$9,989  | March 31, 2015                           | \$2,966 |

The decrease in non-performing loans relates primarily to principal payments received during the first quarter of 2015. Of the \$1.6 million in principal payments received, \$1.3 million related to residential construction loans where the construction had been completed and the borrower paid off the loan from the home sale proceeds.

***Dividends***

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors. The Company suspended dividend payments to common stockholders in the fourth quarter of 2008 due to the net operating losses that were experienced and the challenging economic environment.

On February 17, 2015 the Company paid \$225,000 in dividends to preferred stockholders prior to redeeming the remaining 10,000 shares of its outstanding Preferred Stock. See Note 13 to the Consolidated Financial Statements for further details.

## **LIQUIDITY AND CAPITAL RESOURCES**

For the quarter ended March 31, 2015, the net cash provided by operating activities was \$0.5 million. The Company collected \$18.4 million in principal repayments and maturities on securities during the quarter. It received \$0.2 million in proceeds from the sale of real estate, \$13.0 million in proceeds from borrowings, \$4.4 million related to a decrease in net loans receivable, and \$0.4 million related to increases in customer escrows. The Company had a net decrease in deposit balances of \$13.4 million during the quarter. It also purchased \$34.1 million in securities, paid out \$0.1 million for premises and equipment, repaid borrowings of \$3.0 million, redeemed \$10.0 million of outstanding preferred stock, and paid preferred stock dividends of \$0.2 million.

The Company has certificates of deposits with outstanding balances of \$59.4 million that come due over the next 12 months. Based upon past experience, management anticipates that the majority of the deposits will renew for another term. The Company believes that cash outflow from deposits that do not renew will be replaced with a combination of other customer's deposits or FHLB advances. Federal Reserve Bank (FRB) borrowings or proceeds from the sale of securities could also be used to fund unanticipated outflows of deposits.

The Company had three deposit customers with aggregate deposits greater than \$5.0 million as of March 31, 2015. The \$32.6 million in funds held by these customers may be withdrawn at any time, but management anticipates that the majority of these deposits will not be withdrawn from the Bank over the next twelve months. If these deposits are withdrawn, it is anticipated that they would be replaced with deposits from other customers or FHLB advances. FRB borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The credit policy of the FHLB relating to the collateral value of the loans collateralizing the outstanding advances with the FHLB may change such that the current collateral pledged to secure future advances is no longer acceptable or the formulas for determining the excess pledged collateral may change. The FHLB could also reduce the amount of funds it will lend to the Bank. It is not anticipated that the Bank will need to find alternative funding sources in 2015 to replace the available borrowings from the FHLB. However, if needed, excess collateral currently pledged to the FHLB could be pledged to the FRB and the Bank could borrow additional funds from the FRB based on the increased collateral levels or obtain additional deposits.

The Company's primary source of cash is dividends from the Bank. At March 31, 2015, the Company had \$1.0 million in cash and other assets that could readily be turned into cash. The primary use of cash by the Company is the payment of operating expenses and interest on the note payable to an unrelated third party.

On February 17, 2015 the Company redeemed the remaining 10,000 shares of its outstanding Preferred Stock after redeeming 10,000 shares in the second quarter of 2014 and 6,000 shares in the fourth quarter of 2014. These redemptions reduced the amount of dividends paid on the Preferred Stock and increased interest expense in the first quarter of 2015 when compared to the first quarter of 2014 as the redemption was funded by a \$10 million holding company note payable to an unrelated third party.

The Company also serves as a source of capital, liquidity and financial support to the Bank. Depending upon the operating performance of the Bank and the Company's other liquidity and capital needs, including potentially Company-level expenses, the Company may find it prudent subject to prevailing capital market conditions and other factors to raise additional capital through issuance of its common stock or other equity securities. In addition, regulators have placed increasing emphasis on the amount of common equity as a component of core bank capital, and revised capital regulations (described below) incorporating specific levels of common equity capital both at the Bank and the Company. Additional capital would also potentially permit the Company to implement a strategy of growing Bank assets. Depending on the circumstances, if it were to raise capital, the Company may deploy it to the Bank for general banking purposes, or may retain some or all of it for use by the Company.

If the Company raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, if issued at less than the Company's book value would dilute the per share book value of the Company's common stock, dilute the Company's earnings per share, and could result in a change of control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. The Company's ability to raise additional capital through the issuance of equity securities, if deemed prudent, will depend on, among other factors, conditions in the capital markets at that time, which are outside of its control, and on the Company's financial performance and plans. Accordingly, the Company may not be able to raise additional capital, if deemed prudent, on favorable economic terms, or other terms acceptable to it. If the Company or the Bank cannot satisfactorily address their respective capital needs as they arise, the Company's ability to maintain or expand its operations or operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

The capital requirements of the Company and the Bank were affected by regulatory capital changes that became effective January 1, 2015. The changes established an integrated regulatory capital framework for implementing the Basel Committee on Banking Supervision's Basel III regulatory capital reforms and implement the changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The new capital requirements among other things, apply a strengthened set of capital requirements to both the Bank and the Company and revised the rules for calculating risk-weighted assets for purposes of such requirements. See Note 12 to the Consolidated Financial Statements for additional information on the new regulatory capital rules.

### ***Market Risk***

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its investing, lending and deposit taking activities. Management actively monitors and manages its interest rate risk exposure.

The Company's profitability is affected by fluctuations in interest rates. A sudden and substantial change in interest rates may adversely impact the Company's earnings to the extent that the interest rates borne by assets and liabilities do not change at the same speed, to the same extent, or on the same basis. The Company monitors the projected changes in net interest income that occur if interest rates were to suddenly change up or down. The *Rate Shock Table* located in the Asset/Liability Management section of this report, which follows, discloses the Company's projected changes in net interest income based upon immediate interest rate changes called rate shocks. The Company utilizes a model that uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities under different interest rate changes.

The following table discloses the projected changes in the market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis-point changes in interest rates from interest rates in effect on March 31, 2015.

|   | Market Value |         |         |         |
|---|--------------|---------|---------|---------|
| <i>(Dollars in thousands)</i>               |              |         |         |         |
|   | -100         | 0       |         |         |
| Basis point change in interest rates        |              |         | +100    | +200    |
| Total market risk sensitive assets          | \$558,095    | 551,108 | 539,993 | 528,148 |
| Total market risk sensitive liabilities     | 490,761      | 460,656 | 441,554 | 423,984 |
| Off-balance sheet financial instruments     | (358 )       | 0       | (32 )   | (27 )   |
| Net market risk                             | \$67,692     | 90,452  | 98,471  | 104,191 |
| Percentage change from current market value | (25.16) %    | 0.00 %  | 8.87 %  | 15.19 % |

The preceding table was prepared utilizing a model using the following assumptions (the Model Assumptions) regarding prepayment and decay ratios, which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 4% to 61%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 18% and 138%, depending on the note rate and the period to maturity. Mortgage-backed securities were projected to have prepayments based upon the underlying collateral securing the instrument. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 6% and money market accounts were assumed to decay at an annual rate of 8%. Retail checking accounts were assumed to decay at an annual rate of 3%. Commercial checking accounts and money market accounts were assumed to decay at annual rates of 7% and 12%, respectively. Commercial non-interest checking accounts were assumed to decay at an annual rate of 7%. Callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term instruments exceeded the interest rate on the callable advance or investment.

Certain shortcomings are inherent in the method of analysis presented in the table above. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest index with a similar term to maturity (the Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial sustained interest rate increase.

### ***Asset/Liability Management***



The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the next twelve months to determine if its current level of interest rate risk is acceptable. The following table projects the estimated impact on net interest income during the twelve month period ending March 31, 2016 of immediate interest rate changes called rate shocks.

*(Dollars in thousands)*

| Rate Shock in Basis Points | Projected<br>Change<br>in Net<br>Interest<br>Income | Percentage<br>Change |   |
|----------------------------|---|----------------------|---|
| +200                       | \$ 2,053  | 10.68                | % |
| +100                       | 1,151   | 5.99                 |   |
| 0                          | 0   | 0.00                 |   |
| -100                       | (2,732 )  | (14.21               | ) |

The preceding table was prepared utilizing the Model Assumptions. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income. The increase in interest income in a rising rate environment is primarily because more loans than deposits are scheduled to reprice in the next twelve months.

In an attempt to manage its exposure to changes in interest rates, management closely monitors interest rate risk. The Bank has an Asset/Liability Committee which meets frequently to discuss changes in the interest rate risk position and projected profitability. This Committee makes adjustments to the asset/liability position of the Bank, which are reviewed by the board of directors of the Bank. This Committee also reviews the Bank's portfolio, formulates investment strategies and oversees the timing and implementation of transactions to assure attainment of the Board's objectives in the most effective manner. In addition, each quarter the Board reviews the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

In managing its asset/liability mix, the Bank may, at times, depending on the relationship between long-term and short-term interest rates, market conditions and consumer preference, place more emphasis on managing net interest margin than on better matching the interest rate sensitivity of its assets and liabilities in an effort to enhance net interest income. Management believes that the increased net interest income resulting from a mismatch in the maturity of its asset and liability portfolios can, in certain situations, provide high enough returns to justify the increased exposure to sudden and unexpected changes in interest rates.

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to restructure its balance sheet in order to better match the maturities of its assets and liabilities. In the past, more fixed rate loans were placed into the single family loan portfolio. Over the past several years, the Bank has primarily focused its fixed rate one-to-four family residential lending program on loans that are saleable to third parties and generally placed only those fixed rate loans that met certain risk characteristics into its loan portfolio. The Bank's commercial loan production continued to be primarily in adjustable rate loans with minimum interest rate floors; however, more of these loans were structured to reprice every one, two, or three years.

### ***Off-Balance Sheet Arrangements***

The Company has no off-balance sheet arrangements other than commitments to originate and sell loans in the ordinary course of business.

### **Item 3: Quantitative and Qualitative Disclosures About Market Risk**

Not applicable.

**Item 4: Controls and Procedures**

*Evaluation of disclosure controls and procedures.* As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the Company's management, including the principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal controls.* There was no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**HMN FINANCIAL, INC.**

**PART II - OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in a number of foreclosure proceedings and other collection actions as part of its collection activities. Based on our current understanding of these pending legal proceedings, management does not believe that judgements or settlements, if any and if determined adversely to the Company, arising from pending legal matters individually or in the aggregate, would have a material adverse effect on the consolidated financial position, operating results or cash flows of the Company. Litigation is often unpredictable and the actual results of litigation cannot be determined with any certainty.

**ITEM 1A. Risk Factors.**

Other than as noted below, there have been no material changes to the Company's risk factors contained in its Annual Report on Form 10-K for the year ended December 31, 2014. For a further discussion of our Risk Factors, see Part I, Item 1.A. of the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

*We may issue additional stock, or reissue shares of treasury stock, without shareholder consent.*

We have authorized 16,000,000 shares of common stock. As of April 21, 2015, 4,480,258 shares were issued and outstanding, 4,648,404 shares were held as treasury stock, and 6,871,338 shares were unissued. We also had 833,333 shares of common stock reserved for issuance pursuant to outstanding warrants, 30,000 shares reserved for issuance pursuant to outstanding options and 58,385 shares reserved for issuance pursuant to our equity incentive plans. The board of directors has authority, without action or vote of the stockholders, to issue all or part of the authorized but unissued shares and to reissue all of the treasury shares. Additional shares may be issued, or treasury shares reissued, in connection with future financing, acquisitions, employee stock plans, or otherwise. Any such issuance, or reissuance, will dilute the percentage ownership of existing stockholders. We are also currently authorized to issue up to 500,000 shares of preferred stock, of which 26,000 are designated as shares of Preferred Stock, but none of which were issued and outstanding as of March 31, 2015. Under our certificate of incorporation, our board of directors can issue additional preferred stock in one or more series and fix the terms of such stock without shareholder approval. Preferred stock may include the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion and redemption rights and sinking fund provisions. The issuance of preferred stock could

adversely affect the rights of the holders of common stock and reduce the value of the common stock. In addition, specific rights granted to holders of preferred stock could be used to restrict our ability to merge with or sell our assets to a third party.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. Mine Safety Disclosures**

Not applicable.

**ITEM 5. Other Information.**

None.

**ITEM 6. Exhibits.**

Incorporated by reference to the index to exhibits included with this report immediately following the signature page.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HMN FINANCIAL, INC.

Registrant

Date: May 7, 2015

/s/ Bradley Krehbiel  
Bradley Krehbiel, President and Chief  
Executive Officer  
(Principal Executive Officer)

Date: May 7, 2015

/s/ Jon Eberle  
Jon Eberle, Senior Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

**HMN FINANCIAL, INC.****INDEX TO EXHIBITS****FOR FORM 10-Q**

| Regulation<br>S-K<br>Exhibit<br>Number | Document Attached Hereto   | Reference<br>to Prior<br>Filing or<br>Exhibit<br>Number | Sequential<br>Page<br>Numbering<br>Where<br>Attached<br>Exhibits Are<br>Located in<br>This<br>Form 10-Q<br>Report |
|--|--|---|---|
| 10.1                                   | Non-Employee Director Stock Purchase Plan  | 10.1  | Filed<br>Electronically   |
| 10.2                                   | Description of annual awards to non-employee directors under the 2009 Equity Incentive Plan and form of Restricted Stock Agreement   | 10.2  | Filed<br>Electronically   |
| 31.1                                   | Rule 13a-14(a)/15d-14(a) Certification of CEO  | 31.1  | Filed<br>Electronically   |
| 31.2                                   | Rule 13a-14(a)/15d-14(a) Certification of CFO  | 31.2  | Filed<br>Electronically   |
| 32                                     | Section 1350 Certifications of CEO and CFO   | 32  | Filed<br>Electronically   |
| 101                                    | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended March 31, 2015, filed with the SEC on May 7, 2015, formatted in Extensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheet at March 31, 2015 and December 31, 2014, (ii) the Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2015 and 2014, (iii) the Consolidated Statement of Stockholders' Equity for the Three Month Period Ended March 31, 2015, (iv) the Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2015 and 2014, and (v) Notes to Consolidated Financial Statements. | 101   | Filed<br>Electronically   |